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Public Service Commission of Wisconsin
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Via Electronic Regulatory Filing

July 21, 2008

Ms. Sandra Paske
Secretary to the Commission
Public Service Commission of Wisconsin
610 North Whitney Way
Madison, WI 53705-2729

**Re: Investigation on the Commission's Own Motion Regarding Innovative Utility
Ratemaking Approaches that Promote Conservation and Efficiency
Programs by Removing Disincentives that Exist Under Current Ratemaking
Policies - Docket 5-UI-114**

Dear Ms. Paske:

Please find attached Wisconsin Electric Power Company's Comments to the Survey Questions outlined in the letter dated June 3, 2008, in Docket 5-UI-114. If you have any questions regarding this filing, please contact Mr. T. R. McNeer at 414-221-2568.

Sincerely,

A handwritten signature in black ink, appearing to read "Roman A. Draba". The signature is fluid and cursive, with the first name "Roman" being the most prominent.

Roman A. Draba
Vice President – Regulatory Affairs and Policy

Wisconsin Electric Power Company
Wisconsin Gas LLC
Docket 05-UI-114 Comments

Investigation on the Commission's Own Motion Regarding
Innovative Utility Ratemaking Approaches that Promote Conservation
And Efficiency Programs by Removing Disincentives that Exist
Under Current Ratemaking Policies

Introduction

Wisconsin Electric Power Company and Wisconsin Gas LLC, together d/b/a We Energies submits the following responses to the Public Service Commission's first survey request. Generally speaking, the ratemaking approach that will promote conservation and efficiency programs is an approach that treats utility efficiency and conservation programs the same way generation projects are treated. Capitalization of these program costs allows the utility to earn its authorized return on the projects and does not penalize the utility for decreased sales. We Energies has proposed energy efficiency programs that evolved from its Power the Future projects. In order to develop and spend additional money on energy efficiency programs, current disincentives must be removed.

If a mechanism such as decoupling is to be used, it is important that the mechanism allow for the recovery of fixed costs in the fixed rates, and variable costs be recovered through an adjustment clause or true-up. Any decoupling mechanism should only consider the effects of energy efficiency spending and should not include the effects of other factors such as the economy or the weather. Because of the nature of the commodity, a mechanism like decoupling is better suited for a gas utility than an electric utility.

Q1. Do the current rate structures of the electric and gas utilities in Wisconsin contain a net lost revenue and profit effect that is significant enough to discourage these utilities from developing and spending additional¹ money on energy efficiency programs?

Electric response: Yes. Providing positive incentives for utilities to increase their investment in conservation measures may result in more effective results than discouraging electric utilities from increasing sales. Providing positive incentives such as allowing a return on energy efficiency investments builds on the assumption that a utility will act in its own financial interest. Disincentives are based on the questionable assumption that electric utilities have a significant impact on upward demand growth.

¹ The word "additional" is meant to refer to energy efficiency expenditures that are not otherwise required by law or by Commission order.

Gas response: Yes. However, for gas utilities, the continued on-going rate design movement to recover all fixed distribution delivery function costs through fixed rates (and variable costs through rates applied to quantities consumed) will mitigate the negative revenue impacts for utilities of implementing energy efficiency programs whose goal is to reduce sales. Regardless of the fixed/variable rate design split, the most significant financial benefit to the customer will be realized by avoiding the majority of their utility cost - that which is associated with the cost of the commodity itself

Q2. Is your utility likely to propose energy efficiency spending above current levels if any disincentive to do so is removed?

Response: We Energies is already providing energy efficiency programs in addition to the 1.2% paid into the statewide fund and the Wisconsin Department of Administration low income assistance fee. We Energies has been approved to spend \$18 million annually in 2008 and 2009 for electric and natural gas efficiency programs.

However, removing disincentives is not adequate to encourage expanded energy efficiency spending. A positive incentive in the form of an increased rate of return, bonuses for good performance or similar financial incentives would be necessary for any significant increase in energy efficiency programs. The Company has a fiduciary duty to earn a return for its shareholders and if an investment does not provide a return it is unlikely to be made.

Q3. If disincentives are removed and the utility expects to spend higher than current amounts on energy efficiency is it best for (a) the utility to develop and implement the programs; (b) should that be done by Focus on Energy; (c) should it be done through a combination of the utility and Focus on Energy; or (d) should it be done by some other entity?

Response: The issue of who should run new or expanded programs has no one answer. Using a combination of Focus on Energy and We Energies is an approach that has been piloted in the Company's service territory. While each entity provides advantages and efficiencies, accurately and equitably assigning energy savings to one or the other can be challenging, particularly in light of the fact that each must achieve certain savings levels to meet legal and regulatory requirements.

To avoid redundancy with services already provided by statewide programs, utility programs tend to focus on niche market areas not specifically targeted by statewide programs. Such utility programs can be more expensive to operate though they may also serve a broader market than Focus programs can reach alone.

Q4: Do utilities currently have the resources to develop and implement additional energy efficiency programs?

Response: Currently, the utility has resources (i.e. experienced employees, contractors and adequate funding) to develop and implement its existing energy efficiency programs. To develop and implement additional energy efficiency programs, the utility would need to reevaluate the resources required.

Q5. Should a decoupling mechanism consider only the effects of additional energy efficiency spending or should it also include the effects of other factors such as the economy and weather on actual vs. forecasted sales? If yes, please explain why.

Response: WEPCO's position is that while decoupling may be a preferred method for some utilities in some circumstances to "enable" the development of energy efficiency programs, in and of itself, decoupling is not a sufficient incentive to deliver energy efficiency programs. Should decoupling be adopted, no one mechanism would be appropriate to all utilities in all cases.

The answer to the first part of the question is yes, any decoupling mechanism should only consider the effects of additional energy efficiency spending. The answer to the second part of the question is No, a decoupling mechanism should not include the effects of other factors such as the economy and weather on actual vs. forecasted sales.

Q6. If you answered yes to Question #5, should it be necessary for a utility to propose additional energy efficiency spending before it could seek recovery of any lost revenues due to other factors?

Response: the Company's response to #5 was No. Other factors should not be considered.

Q7: If a decoupling mechanism considers only the effects of additional energy efficiency spending, but due to weather, economic, or other factors the overall sales are equal to or greater than forecast, or if due to other factors the utility is either earning its authorized ROE or is within some range of its authorized return, should it still recover lost revenues?

Response: Yes. This question is based on an asymmetrical treatment of earnings, whereby the utility could only recover revenues lost due to successful energy efficiency programs if it was sufficiently under-earning its authorized return. This is inappropriate. To the extent that additional energy efficiency spending reduced consumption and/or caused lost revenues, the utility should be made whole by the mechanism employed.

The purpose of this docket is to discuss what disincentives need to be removed under current ratemaking policies. If a utility is only allowed to recover lost revenues when it is under-earning its authorized return, i.e. the decoupling mechanism only adjusts revenues for the effects of additional energy efficiency, an additional disincentive to promoting conservation and efficiency programs would be introduced. If the utility would still have a disincentive to add to its existing risks by promoting less use of its product when other factors can cancel out the return that should come with the increased risk – namely the decoupling mechanism designed to keep investors whole for these programs.

Q8. Please provide what you believe to be the key components of a decoupling mechanism.

Response: As outlined in the electric utility's response to Q5, there is no one decoupling mechanism that can fit all utility situations. Each utility should propose what would fit their

unique circumstances. If decoupling is implemented, a mechanism proposed by staff in Q 13 is an example of an acceptable approach provided the mechanism only considers the effects of additional energy efficiency spending.

Q9. Please provide examples of ratemaking mechanisms other than decoupling that could incent utilities to pursue additional energy efficiency spending at a reasonable cost to ratepayers.

Electric response: From a cost-recovery perspective, allowing a return for the utility's investment in energy efficiency programs as a form of alternative generation would have the effect of attracting capital to support such initiatives, thereby replacing not increasing costs of generation that would necessarily push consumer prices up.

Gas response: We believe that prices that recover fixed costs in fixed rates and variable costs in rates applied to quantities consumed for the distribution service function costs of service will mitigate disincentives. Collecting variable gas costs, since they are the largest component of sales customers' bills, based on consumption will provide the customer with the most incentive to reduce their consumption levels over time.

Q10. Should all customer classes be included in any mechanism that is implemented to encourage utilities to promote additional energy efficiency spending? Why or why not?

Response: Generally speaking, no. Notwithstanding the Act 141 requirement that all customers should contribute something to energy efficiency funding, to the extent a benefit to the customer or class of customers either directly or indirectly can not be identified; they should not be required to participate or be mandated for inclusion in the mechanism attributes.

Q11. If your answer to Question #9 is no, should additional energy efficiency programs only be designed to benefit only participating customer classes? Why or why not?

Response: No. We believe that energy efficiency programs should be designed to achieve the maximum energy efficient market possible. Inefficient consumers of energy should be the target of any programs. As such, program designs should not be done in a vacuum bound by customer rate classes or utility groupings. We believe to achieve the most efficient use of the gas commodity or electric service; individualized customer programs will be required. As for cost recovery of the programs, see answer to Q 10.

Q12: Do you foresee controversy in determining the amount of reduced kWh sales caused by additional energy efficiency spending and the dollar margin on the reduced sales used to determine the under recovered amount to be included in rates? Why or why not?

Response: Yes. As long as rates are based on sales, and especially on forecasted sales, one can expect controversy in determining the appropriate values to use for the factors believed to drive those sales.

If rates are based on something other than sales, a fixed revenue quantity for instance, determining the amount of reduced sales to attribute to additional energy efficiency spending (or anything else, for that matter) becomes almost academic. Such an approach, however, would likely produce more volatile rates and require some sort of “true-up” mechanism.

Q13. Considering the lag time between the design and implementation of energy efficiency programs and that utilities file regularly for rate reviews, would the following alternative to decoupling be useful in removing disincentives to utilities promoting these programs? For programs that a utility is proposing prior to a rate case filing an estimate of reduced sales would be made and the test year sales forecast would be reduced accordingly. For programs developed and implemented during the utility’s biennial period, a decoupling mechanism could be used to adjust for the impact of these programs until the next rate period (it would be likely that the lag time in implementing programs would make revenue adjustments relatively small).

Response: Given previously stated preferences for alternatives to uniformly-applied decoupling mechanisms, this would be an alternative to full decoupling that may be worthy of further review.

Q14: Is revenue decoupling illegal retroactive ratemaking? Why or why not?

Response: No. In general, the prohibition against retroactive ratemaking prohibits the Commission from trying to recapture expenses incurred above or below levels set in a prior rate case. Revenue decoupling does not change the rate base nor does it change the rate of return set in a rate case. Decoupling simply matches the revenues collected to align with actual sales. If approved as part of a rate case, decoupling works on a forward-looking basis in that the tariffs explicitly authorize the true-up mechanism to be used until the utility’s next rate case.

Q15. Are you aware of mechanisms other states use to incent additional energy efficiency on behalf of their utilities that you believe would be successful in Wisconsin? Is so, please identify those states.

Response: The Company has not done an exhaustive analysis of the following proposals. These three are notable in that they contain incentive mechanisms.

The California order (R.06-04-010) has an incentive plan. The California system sets an acceptable energy efficiency performance level. Performance below 65% of that level results in penalties. Performance above 85% of the goal results in the dollar benefits being split between ratepayers and shareholders.

A proposal presented by Duke Energy (Docket E-7, Sub 831) would allow Duke to earn 90% of what it would have earned if it had to build a generating plant instead of saving the energy.

A recent Colorado order (Docket No. 07A-420E) permits a higher rate of return for designated amounts of energy savings.

Q16: Does a decoupling mechanism represent a reduction in risk to the utility? If so, should that be reflected in the authorized return on equity?

Response: No, from a pure financial theory basis a decoupling mechanism that adjusts only for the effectiveness of energy efficiency programs would not reduce investors' non-diversifiable risk. According to financial theory the estimation of return on equity only measures the non-diversifiable risks that an investor faces. As stated numerous times in Wisconsin regulatory proceedings by a number of staff and expert witnesses (both company and intervenor), the return on equity should reflect the firm's sensitivity to macroeconomic factors (non-diversifiable risk) and not business specific factors (diversifiable risk). A decoupling mechanism appears to be business specific and therefore would not impact the estimation of return on equity.

Therefore, adopting a decoupling mechanism should not factor into the estimation of return on equity.

However, from a specific business risk standpoint, reducing the sales growth potential of the utility adds to the business-specific risk of the utility. Spending significant additional sums of money on energy efficiency programs to achieve the aim of reducing sales growth is inexpedient. Decoupling can be thought of as an offset to this particular risk only.

Q17. What process should the Commission use to establish the parameters of ratemaking approaches that promote energy efficiency; i.e., should the Commission approve utility-specific plans or establish guidelines for implementation in rate cases?

Response: Utility specific plans are most appropriate. Unique markets with unique customer needs and opportunities, timing of rate proceedings, administrative limitations, legislative or PSCW mandates and their relative timing, court rulings, current utility programs and/or incentive mechanisms, separate rate class structures with unique rate designs, and many other reasons support utility-specific approaches.

Q18. Are there important differences between gas and electric utilities to be considered when designing an incentive mechanism?

Response: Yes. There are several important differences, including:

- 1) Timing of changes in pricing to customers; e.g. gas utility monthly price changes and daily cash out as compared to electric price changes authorized by the fuel rules. The timing of price changes may impact customer elasticity response differently and will be further influenced by the magnitude of the price change.
- 2) Consumer service offering differences, e.g. bundled electric vs. unbundled gas service. For example, the gas transportation customer purchases the commodity from an entity other than the company at an unknown price. Additional service offering differences such as fixed bills (e.g.

rely-a-bill), fixed price options, time of use, natural gas vehicle or agricultural crop drying will need to be considered in the mechanism design.

3) The definition of customer “classes” is not uniform between gas and electric utilities.

4) Some gas consumers have multiple fuel options such as dual fuel customers (wood, oil, diesel fuel, propane, coal) that, on short notice can choose to switch fuels. These same customers may not use natural gas for extended periods of time such that timing for revenue adjustments will need to accommodate this difference.

5) Unique customer use profiles primarily driven by their unique processes (in addition to those identified in #3. above) that result in significantly different seasonal load factors (which would significantly impact mechanism, design, application, and performance) will need to be identified as well.